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Our Ref: MPFA773

BY HAND

10 October 2014

Mr Darren McShane
Chief Regulation & Policy Officer
Mandatory Provident Fund Schemes Authority
23/F., Nexxus Building
41 Connaught Road Central
Hong Kong

Dear Darren

Core Fund

We have reviewed the consultation paper jointly issued by the FSTB and the MPFA, and attached the following comments for the MPFA's consideration.

Q1. Do you support the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d)?

☐ Yes ☐ No ☑ It depends

Generally, we support the direction of adopting a more uniform approach to setting the default fund. Current MPF companies use different default funds for their schemes. There might be a need to align the default funds. However, we believe the FSTB and the MPFA must first determine what type of a default option is the most appropriate for a retirement plan, and to clarify the intentions of such default option. If intended to address the small minority of members who chose not to make an investment decision, then the default option can be rather simple and straightforward. If the intention is to create a default option to address a broader concern, then the intention needs to be clearer and better communicated to the general public.

Rather than calling the new retirement investment strategy a "core fund", we believes these retirement strategies could be called "default investment fund" or "default option" to avoid any value judgment being imposed onto this product and potentially mislead members.

Q2. Do you agree that the CF that is the default fund should be substantially the same in all MPF schemes?

☑ Yes ☐ No

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Q3. Do you agree that it is appropriate that the core fund (default option) be based on a standardized default fund?

☐ Yes ☑ No

Given that there are multiple ways of achieving the same investment objective, we believe different providers can have their own default fund.

Q4. Do you agree that the appropriate investment approach of the core fund (default option) is one that automatically reduces risk over time as the member gets closer to age 65? If not, what other option would you propose?

☐ Yes ☑ No

We prefer a single fund approach which can be easily understood by members and be able to deliver consistent investment return to default members at all times.

Q5. Do you have any preliminary views on the technical issues set out in paragraph 48, in particular whether consistency is required on all aspects of default fund design in all schemes or can some elements be left to the decision of individual product providers?

As stated in Q4, we prefer a single fund approach rather than target date funds or life cycle funds.

Q6. Do you agree that keeping total fee impact for the core fund (default option) at or under 0.75% is a reasonable initial approach?

☐ Yes ☑ No

We are of the view that keeping the total fee impact for the default option at or under 0.75% is NOT a reasonable initial approach. Our conviction rests on the following facts:

a) In reference to the 2012 Consultancy Report commission by the MPFA on a study of the administrative cost in the MPF system, it clearly indicated that, at the time of that Report, the overall weighted average FER was 1.74% in which the average administration cost and investment management fee accounted for 0.75% and 0.59% respectively. It is obvious that fees have declined in the past few years and we believe such reductions will continue and will ultimately be reflected in the FER. It should be noted that the published FER does not reflect bonus units being rebated to members which effectively further reduces the actual fee paid by members.

b) Simultaneous to a gradual decline of fees, providers have also spent resources in offering e-

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channels for employers and members, as well as engaging and supporting many initiatives required by the MPFA on streamlining administrative processes (i.e., ePass and TRIS), amidst coping with tightened compliance requirements which have added to costs for the system overall. As such, we have not seen cost savings on administration, which is the key driver of a lower FER.

c) Furthermore, we do not see how the current stage of regulatory requirements on MPF operations could accelerate any reduction in administration cost to a drastically lower level. In conclusion, to achieve better cost savings in the long run, the MPFA should take the lead with joint efforts from the industry to promote the use of e-channels, which have not yet been widely accepted and utilized by employers and members.

d) In 2013 the MPFA published a listing of funds with total fee and total expenses ("FER") of 1.3% or less has set an unofficial benchmark for the definition of "low fee". Such has been widely accepted by the market as a synonym for "low fee fund". The proposed fee of the default option is now hinged on a significant negative variance of over 30% compared to the "low fee fund" listing. We are gravely concerned about the drastic fee reduction assumption made within such a short period of time which is also unsubstantiated.

e) To develop a low fee "default option", the consultation paper proposed using an index-based, passive investment strategy. Yet the number of applicable ITCIS's, especially in the bond category, is small to support this strategy. There are only five fixed income ITCIS's, of which none tracks global government bonds. The overall average FER of the currently available ITCISs is as high as 0.45%, with the FER of some single country ITCISs in the 0.6% - 0.7% range. In this respect, using a passive investment strategy will not necessarily result in a low fee fund.

f) If we are required to meet more stringent fee caps, we might have to reduce services or find other means to offset the costs of offering a default fund. The fact is that only the investment manager fee would benefit even with a sufficient asset scale. In fact, there will be no reduction on the administration fee since a reduction in administration processing is unlikely (if not increased). To the trustees and administrators, true saving could only come if there is a wide-spread use of electronic platforms. From page 29 of the Managing the changing landscape of retirement savings – Report on a study of administrative costs in the Hong Kong Mandatory Provident Fund system by Ernst & Young, the first of the 4 suggested cost savings measures was "Industry wide initiatives to transition to end-to-end online and electronic payments processing to reduce costs and streamline processing". According to this Report, the savings is expected to be at approximately 0.2%.

Therefore, we believe it is vital for the MPFA to work with the industry to promote the use of electronic contribution and payment platform as one of the ultimate solutions to help drive costs down.

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We believe fee and expense levels will be reduced as administrative cost savings (including regulatory imposed costs) are realized and fund size further increases to create sufficient scale in the MPF system. At present, the current asset size of the Hong Kong MPF market lacks scale to significantly drive cost down within a short period of time.

Q7. Do you agree that keeping total expense impact (i.e. FER) for the core fund (default option) at or under 1.0% over the medium term is a reasonable approach?

☐ Yes ☑ No

As stated in Q6, we are of the view that keeping the total expense impact for the default option at or under 1% over the medium term is NOT a reasonable approach.

We propose an FER of 1.5%.

Q8. Do you agree that passive, index based, investment strategies should be the predominant investment approach in the MPF core fund (default option)?

☐ Yes ☑ No

We have reservations over the usage of the word 'predominant'. While passive or index based investment strategies might form part of the strategy, we believe the decision on overall investment approach should be left to each individual MPF scheme provider and fund managers. We note in some jurisdictions such as the US where both passive and active investment strategies are offered, and investment flows are fairly split between the two options. Each MPF scheme provider should be able to assess their customers' expectations and desire, and then design core fund options (considering performance and fees) that provide the best value to members.

Q9. Are there particular asset classes which you think would not appropriately be invested on a passive, index based approach?

Our general view is that if the liquidity or trading volume of some asset classes is very thin, the lower level of liquidity would increase expenses.

Another point we would like to mention is that for many (if not all) bond ETFs, the existing indices they track could have elements that do not meet the MPFA's investment requirements (e.g. on the credit rating of the bonds or type of bonds). Hence, separate ETFs may need to be created. New ETFs may lack liquidity and size which again would have ramifications on the liquidity concerns and the FER. Furthermore, bond ITCISs generally have difficulties in mimicking all the constituents of the indices that they are tracking, which means members may have to bear relatively high tracking errors for these ITCISs.

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Q10. Do you agree that the name of the core fund (default option) should be standardized across schemes? If so, do you have any preference amongst the possibilities set out in paragraph 77?

☑ Yes ☐ No

Our preference is:

☑ "MPF Default Investment Fund" (reinforcing that its primary design is built around the default investment strategy for those who do not, or do not want to make an investment choice in saving for retirement)

Q11. Do you agree with the general principle for dealing with implementation and transitional issues as set out in paragraphs 78 and 79?

☐ Yes ☑ No

We understand the rationale behind the general principle for dealing with the implementation and transitional issues proposed by MPFA in the Consultation Paper, but we do not agree with the entirety of the implementation and transitional arrangements. Whilst the we agree that all existing MPF scheme members should be made aware of the new default option arrangements, we do not agree that members currently investing into existing default funds would need to switch to the new default options nor should the future contributions be automatically invested into the new default option. We also have the following concerns:-

a. Given the size of the MPF market as well as the amounts invested in the existing default funds, there would be significant transactions (in respect of both subscription and redemption) for particular securities in a single day, and such an arrangement may lead to unexpected price fluctuations which may not be in the best interest of the MPF scheme members.

b. If the current default fund is a guaranteed fund, there is also the concern that these members who are being forced to switch to a new default options may not be able to benefit from the guarantee, which may only be realized upon satisfying certain conditions in the future.

c. There may be situations where existing members are not aware of the notification / new arrangement due to various reasons such as out-of-town, invalid contact details, etc., which could result in these members being forced to invest into the new default option, which might not to be in their best interest.

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d. Members may not consent to such a change in their investment portfolio and could make claims for decreases in asset value associated with such a change.

e. Existing members who have multiple accounts within a MPF scheme may have different investment choices. The proposal creates complications in the communication with scheme members.

f. Existing members could submit switching instruction at any time. Thus, they have opportunities to invest into the new default fund if they elect to do so.

g. Some MPF schemes may have a number of "dummy" account members (i.e. employees who are not properly enrolled in the scheme) where the relevant trustees just only have the name or HKID/passport number of these "dummy" account members. As these trustees do not have the actual date of birth for these members, the using of glide path to reduce risks may not be appropriate for them. In case the transitional arrangement as set out in paragraphs 78 and 79 will be implemented (especially for existing dummy account members where members' existing benefits will be switched to the new "default/core" fund), we suggest applying the glide path applicable to the risk profile for age 65.

Due to our concerns above, we recommend the new default option arrangement should only be applied to new MPF scheme members. We do, however, agree that existing MPF scheme members would only switch into the new default option by making a specific investment choice.

In addition, we believe the MPFA could further improve upon the proposed arrangement by taking into account of the following:-

1. The transitional arrangement shall be set out specifically in the amendment legislation and regulations, especially when it involves switching of members' accrued benefits from the existing default fund to the new default option. The amendment legislation or regulations should cover but not be limited to an aligned switching dealing date to the default option, handling of members who cannot be contacted, and how the members are classified as investing in existing default fund.

2. Due to the potential effect of the arrangement, we recommend that the government or the MPFA carry out promotional and educational programs and have extensive coverage to the public on the transitional arrangement prior to the launch of the default options.

3. MPFA must also provide all trustees with specific guidance in relation to the submission of applications for the addition of default options (e.g. including guidance on standard wordings for the objectives, restrictions, risk disclosures, timetable, etc.).

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Q12. Do you agree with the proposal in paragraph 81 as to how to deal with the transition for existing MPF members of default funds?

☐ Yes ☑ No

In relation to the existing members we cannot readily identify as having made an investment choice, we are of the view the invested contributions, or future contributions, should not be switched from the existing default fund to the new default option even if they have failed to make another investment choice. In addition to the concerns mentioned in Q11, the transitional arrangement should be standardized and one standard rule applied to all MPF schemes in order to ensure efficient and effective communication with all members.

Q13. Other items

Regarding the points raised in Darren McShane's letter dated 25 September 2014 to trustees on the following:

- **The government or some government agency should take a role in operating the core fund and/or in investing the funds of the core fund**
- **There should only be a single core fund rather than core funds in each and every MPF scheme.**

Our view is as follows:

The government or some government agency should take a role in operating the core fund and/or in investing the funds of the core fund

Before considering whether to take-up an operating role, the Government should

- have a clear definition on what is a Core Fund (not only default fund);
- have a clear message to the public on the proposal of whether they want to introduce a fund with low fee, reasonable good performance, and suitable for majority of non-sophisticated members;
- be prepared to see demands from the public for returns with guarantee to beat potentially high inflation, and
- be prepared to sort-out all the administrative logistics.

The last thing everyone wants to see is a false impression that a Core Fund operates by the Government is the best among all available fund choices.

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If the Government is involved in the whole set up of the core fund, the core fund would achieve better economies of scale. However, there will likely be issues on aspects like the cash flow management, transfer in/out, allotment/redemption, reporting (scheme member communication) and servicing. Hence, the Government is advised to further consult with the industry on the related arrangements.

Given MPF is a privately run system regulated by the government, it would be more appropriate to maintain status quo in order to maintain operation efficiency and avoid unnecessary disturbance. As a rule of thumb, market forces drive pricing efficiency and a government-mandated Core Fund would undermine the free market competition. The policy intent of the government for the MPF regime is to have it private managed with government oversight. If the government wishes to be involved in operating or managing the "core fund", then this change of policy intent should be widely consulted and debated among relevant stakeholders.

We believe the default arrangement should adopt an approach that results in reasonably consistent outcome across schemes and we also support the regulators to issue guidelines rather than prescribing standardized the underlying APIFs for the default arrangement. We believe flexibility should be given to individual providers in deciding the investment strategy or product mix to allow for innovation in the industry.

We believe a government agency will face the same issues as the trustees in terms of designing a product (i.e., glide path, investment strategy, lack of ITICS, etc.) as well as difficulty in achieving the targeted fee levels especially with insufficient AUM.

Will the Government

- manage the fund directly?
- be subject to the same investment restriction and MPFA oversight as trustees?
- assume the fiduciary role for the product?

The Government could use a third party manager(s). However, it is likely that it will be difficult to achieve the fee target by having to pay third parties. In addition, if the Government is involved, the fund performance, both good and bad, will be fully responsible by the Government, and bear the political responsibility. The Government would likely be receiving a lot of complaints/challenges during the time of poor fund performance. We see a potential conflict of interests if the government manages the Core Fund while monitors the investment performance of all MPF funds.

Who will bear the administrative costs? Contributions, distributions, reporting, etc..., must still be done. The industry is willing to compromise to offer low-fee Core Fund with standardized investment approach. It is not necessary to have government intervention.

Even if the Government or some Government agencies could provide the services to operate the core fund under Trustee delegation, we sincerely doubt if this could be achieved at a reasonable

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cost. With the Government taking full responsibilities in doing so, there is the advantage of not needing to perform due diligence on the Government. However, if the provision of operation/investment arrangement for the core fund is outside of the current MPF arrangements, this could create another level of interaction with the Government or some Government agencies for the trustee, and we do not see it as the most efficient arrangement for it will not be in the best interest of members.

There should only be a single core fund rather than core funds in each and every MPF scheme

We disagree that the core funds of different MPF schemes should be invested into the same APIFs. We believe flexibility (e.g. on the choice of APIFs and certain aspects of the design of the core fund) should be allowed for investment managers to make the appropriate investment decision on behalf of members.

There will be a lack of competition if only one set of APIFs or index funds is allowed for all the MPF schemes. Concentration risk on return/performance (i.e., if the fund does not perform) will be very high, potentially leading to the returns of a significant number of members being affected. The consultation paper indicated around 24.1% of members had not made a fund choice. We expected more members will pick this fund if it's packaged by the MPFA as a "core" investment strategy with low fee/high return.

A single Core Fund would create a lack of market competition to drive pricing efficiency and investment outcome. Furthermore, it would be a non-level playing field as small fund house could not compete with the international firms to provide that single Core Fund.

If members do not satisfy with the performance of the single Core Fund, there will be no other choices.

There will be a question of who shall select the single Core Fund for all MPF schemes. If chosen by the Government, there will be conflict of interest.

Should you have any enquiries, please feel free to contact the undersigned on

Yours sincerely

Shirley Li
Senior Manager
Compliance & Trust Services